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IN THE

Supreme Court of the United States

October Term, 1937.

No. 287

EDWARD MCLOUGHLIN,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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New York City,
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The Petitioner, by his counsel, hereby prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit entered in the above cause on May 3, 1937, affirming the decision of the United States Board of Tax Appeals.

Opinions Below.

The opinion of the United States Board of Tax Appeals (R. 87-8) is reported in 34 B. T. A. 963. The opinion of the Circuit Court of Appeals for the Second Circuit is reported in 89 F. (2d) 699.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered May 3, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The question presented is whether the amounts received by the Petitioner as compensation for services as a member of the legal staff of the New York State Insurance Department are subject to federal income tax.

Statutes and Regulations Involved.

The pertinent statutes and regulations will be found in the Appendix, *infra,* pages 9 and 10.

Statement.

Petitioner in 1929 was appointed Secretary to the then Superintendent of Insurance of New York. In 1930 he was appointed a member of the legal staff of the Liquidation Bureau, a branch of the Insurance Department, and continued in this capacity to and through 1932, the taxable year involved (R. 33-34). The term "Liquidation Bureau" has no statutory significance; it is merely a convenient description used to designate those employees of the State Insurance Department who, as a group, are engaged in carrying out the liquidating function of the Superintendent of Insurance.

The Board found as a fact that:

> "The petitioner gave full time required of employees in the liquidation bureau, and his hours were from 9 a. m. to 5 p. m., the same as attaches of that bureau who were not engaged in legal work" (R. 71-72).

The Liquidation Bureau was created in 1909 (R. 37) and its work consists of adjudicating claims, marshalling and liquidating the assets of dissolved companies. After all

of the assets of a company have been realized upon, dividends are distributed pro rata to the claimants entitled under the laws of the State of New York to participate in the assets of a defunct insurance company (R. 41). When a court order is obtained directing liquidation of an insurance company, its charter is dissolved and no new business is transacted (R. 41). In the rare instances when there is money left over after payments to policyholders and creditors such balance is distributed to the stockholders of the company (R. 42). In legal matters involving companies in liquidation, the petitioner appeared as the attorney of record and he devoted over 90% of his time during 1932 to legal problems and cases involving the companies in liquidation whose affairs were being administered at the 80 Center Street office of the Insurance Department (the State Building). The balance of his time was devoted to legal problems of the Bureau as a whole, such as the drafting of new Article XI of the Insurance Law (R. 47).

Petitioner's salary was paid bi-monthly by pay checks issued in the name of the New York State Insurance Department, Liquidation Bureau, and signed by the Chief of the Liquidation Bureau, and drawn on the Bank of New York and Trust Company, 48 Wall Street, New York City (R. 51—Ex. C. R. p. 22). The funds deposited in this account out of which petitioner and the other employees of the Bureau were paid were provided by checks drawn on the bank accounts of the various companies in liquidation and in turn deposited with the Bank of New York and Trust Company to the credit of the Liquidation Bureau. Petitioner's compensation for 1932 was pro rated to the companies in proportion to the time devoted by him in connection with the respective companies on the legal affairs of which he was engaged (R. 48-49). The time devoted by

him to the general legal problems of the Insurance Department would be pro rated among the various companies under a formula designed to charge general administration expenses to the company in liquidation in proportion to the aggregate compensation of those engaged in the specific liquidation of the respective companies (R. 48-51).

In 1932 the petitioner received $5,125 as compensation for his services to the New York State Insurance Department. The Commissioner of Internal Revenue ruled that the compensation was income subject to federal income tax, and, on appeal to the United States Board of Tax Appeals and the United States Circuit Court of Appeals for the Second Circuit, the Board and the Court respectively sustained the Commissioner's ruling.

Specification of Errors to be Urged.

The Circuit Court of Appeals erred:

1. In holding that the compensation received by the respondent from the New York State Insurance Department was subject to Federal income tax.

2. In holding or implying that the function of the New York State Insurance Department in liquidating insolvent insurance companies is a proprietary rather than a governmental function.

3. In holding or implying that because the petitioner's compensation was paid by the New York Insurance Department from funds derived from the assets of the insurance companies in liquidation rather than out of the general funds of the State, the compensation is taxable.

Reasons for Granting the Writ.

1. The decision of the Court below appears to be based on two grounds: First, that the function of the State of New York in liquidating insurance companies is *proprietary* rather than governmental, and second, that because the salary of the petitioner was paid out of the assets of the insurance companies being liquidated rather than out of general funds belonging to the State, the salary is taxable.

a. On the first point—the alleged non-governmental character of the Liquidation Bureau—the Court's decision is in conflict with the decision of the United States Court of Appeals for the Fifth Circuit in *Therrell* v. *Commissioner*, 88 F. (2d) 869 (1937), in which the Court held that Therrell, who was appointed by the State Comptroller of Florida to liquidate a number of insolvent banks in Florida, was not subject to Federal income tax on the commissions received by him for his services as liquidator.*

In petitioning this Court for a writ of certiorari in the *Therrell* case, which petition is now pending, the Solicitor General of the United States stated that:

> "the decision in the instant case is in direct conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *McLoughlin* v. *Commissioner*, decided May 3, 1937 • • •."

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* The facts of the present case are more strongly in favor of the taxpayer than those in the *Therrell* case because in that case the facts tend to indicate that Therrell was to some extent an independent contractor, and under the decisions of this Court in *Metcalf and Eddy* v. *Mitchell*, 269 U. S. 514 (1926) and *Commissioner* v. *Howard*, 280 U. S. 526 (1929), the compensation received from a state by an independent contractor is taxable. In the present case the Government conceded at the argument before the Court below that McLoughlin was a regular state employee, not an independent contractor.

Petitioner submits that the statement of the Solicitor General as to the direct conflict between the *Therrell* and *McLoughlin* decisions is clearly sound.

b. On the second point—the fact that Petitioner's compensation is paid out of the assets of the insurance companies—the Court's decision in the present case is in conflict with the following decisions in other Circuits:

> *Therrell* v. *Commissioner, supra;*
> *Hoskins* v. *Commissioner,* 84 F. (2d) 627 (1936) (C. C. A. 5);
> *Bettman* v. *Warwick,* 108 Fed. 46 (1901) (C. C. A. 6).

In the *Therrell* case the compensation in question was paid out of the assets of the banks in liquidation; in the *Hoskins* case out of the income of cafeterias in public schools run by the Fort Worth, Texas, School District. In both cases the courts held the compensation was exempt from tax. In the *Bettman* case the Court held that a Federal stamp tax could not be imposed on the certificate issued to a notary public by the State of Ohio, even though his compensation was collected from the persons using his services rather than from the State.

From a statement by the Circuit Court of Appeals for the Second Circuit in the recent case of *Harman* v. *Helvering* (not yet reported), decided June 14, 1937, it appears that even that Court now recognizes that the fact that payment is not made out of state funds is not, a tenable ground for holding the compensation of a state officer subject to Federal income tax. The Court said:

> " * * * it is tempting to say that, as the state's treasury is not concerned, the tax must necessarily be valid. But the cases will scarcely bear out such a test, * * *. It was repudiated in *Bettman* v. *Warwick,*

108 Fed. Rep. 46 (C. C. A. 6), and we refused to base our decision upon it in *McLoughlin* v. *Commissioner*, 88 Fed. (2)."

Furthermore in the recent case of *New York ex rel. Rogers* v. *Graves*, 299 U. S. 401 (1937), this Court held that the salary of the general counsel of the Panama Railroad Company was exempt from New York State income tax because the railroad is an instrumentality of the United States, even though the record showed that the salary was paid out of the earnings of the Railroad Company.

2. The decision of the Court fails to give effect to the distinction drawn by this Court in *Ohio* v. *Helvering*, 292 U. S. 360 (1934), between the *Governmental* and *proprietary* activities of the states. This Court, in sustaining a Federal excise tax imposed upon the liquor business conducted by the State of Ohio, distinguished its decisions in *Indian Motocycle Co.* v. *United States*, 283 U. S. 570, 575 (1931), *McCulloch* v. *Maryland*, 4 Wheat. 316, 436 (1819), and *Collector* v. *Day*, 11 Wall. 113 (1870), by pointing out that:

> "But, by the very terms of the rule, the immunity of the states from federal taxation is limited to those agencies which are of a governmental character. Whenever a state engages in a business of a private nature it exercises non-governmental functions, and the business, though conducted by the state, is not immune from the exercise of the power of taxation which the Constitution vests in the Congress" (p. 368).

If the State of New York should enter the insurance business, as many have urged that it ought to do, such activity would doubtless be classified as proprietary and the compensation paid by the State to those employed in conducting this business would, therefore, be taxable by the Federal Government. *Helvering* v. *Powers*, 293 U. S. 214

(1934). But the present activities of the New York Department of Insurance, including its liquidation of insolvent insurance companies, are purely regulatory and supervisory, *i. e.*, of a truly governmental character, and compensation of its employees engaged in these governmental activities is exempt. *Collector* v. *Day, supra.* There would appear to be less ground for doubt as to the governmental character of the States' function in the present case than in *Brush* v. *Commissioner,* 57 Sup. Ct. 495 (1937) in which this Court held that the compensation received by the Chief Engineer of the Bureau of Water Supply of the City of New York is not subject to federal income tax.

3. The question in this case is of current administrative importance. Similar questions are now pending before the Circuit Court of Appeals for the Third Circuit in *Freedman* v. *Commissioner,* 34 B. T. A. 956, and before the Circuit Court of Appeals for the Sixth Circuit in *Hanrahan* v. *Commissioner,* decided by a memorandum opinion of the United States Board of Tax Appeals on November 12, 1936.

There are a number of other similar cases pending in the United States Board of Tax Appeals which will presumably be appealed to the appropriate Circuit Courts of Appeals unless the issue in the present case is decided by this Court in the near future.

Conclusion.

It is in the public interest that the conflict here presented be resolved by an authoritative decision.

Wherefore, it is respectfully submitted that this petition should be granted.

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Counsel for the Petitioner.

APPENDIX.

Statutes and Regulations Involved.

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, • • •.

Treasury Regulations 77:

ART. 643. *Compensation of State officers and employees.*—Compensation paid to its officers and employees by a State or political subdivision thereof for services rendered in connection with the exercise of an essential governmental function of the State or political subdivision, including fees received by notaries public commissioned by States, is not taxable. Compensation received for services rendered to a State or political subdivision thereof is included in gross income unless (a) the person receives such compensation as an officer or employee of a State or political subdivision, and (b) the services are rendered in connection with the exercise of an essential governmental function. The commissions of receivers appointed by State courts are taxable.

New York Insurance Law, Article I § 63 (6):

6. For the purposes of this section, the superintendent shall have power to appoint, under his hand and official seal, one or more special deputy superintendents of insurance, as his agent or agents, and to employ such counsel, clerks and assistants as may by him be deemed necessary, and give each of such persons such powers to assist him as he may consider wise • • •.

Article XI § 414:

Appointment of deputies; employment of assistants; payment of salaries and expenses. 1. For the purposes of this article the superintendent shall have power to appoint under his hand and official seal, one or more special deputy superintendents of insurance, as his agent or agents, and to employ such counsel, clerks and assistants as may by him be deemed necessary, and to give each of such persons such powers to assist him as he may consider wise.

2. The compensation of such special deputy superintendents, counsel, clerks and assistants, and all expenses of conducting any proceeding under this article shall be fixed by the superintendent, subject to the approval of the court, and shall, on certificate of the superintendent, be paid out of the funds or assets of such insurer.

New section. Added by L. 1932, ch. 191, § 1, in effect March 15, 1932.